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OCTOBER TERM, 1900.

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No. 150.

UNITED STATES RUBBER COMPANY ET AL.,
PETITIONERS,

vs.

AMERICAN OAK LEATHER COMPANY ET AL.,
RESPONDENTS.

CERTIORARI TO CIRCUIT COURT OF APPEALS FOR THE SEVENTH CIRCUIT.

REPLY BRIEF FOR PETITIONERS.

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PETITIONERS' REPLY.

I.

THE QUESTION OF SECRECY.

The oral arguments have emphasized the fact that the change of by-laws and directors is no longer seriously relied upon to establish constructive fraud. Counsel, however, rely much upon the intentional silence, or (as they call it) secrecy, to make a case of fraud.

The real question here is *whether an embarrassed debtor*

may lawfully use his right to prefer to aid him in his efforts to "weather the storm." If so, the right to remain silent (when not asked questions) respecting his embarrassment and his efforts to outlive it necessarily exists. To require him to proclaim the preference by which he secures the new loan of money, and thus to deny him the right to continue, as before, to purchase on credit, is to deny him the right to struggle on and use his right to prefer in doing so. Such a law would require him to suspend business as soon as he becomes embarrassed.

Of course the distinction is here to be made—and is overlooked by counsel—between an unqualified *agreement* to keep secret as part of the preferential contract and mere intentional or premeditated silence. The former implies that each party when questioned must misrepresent, and may well be held to indicate a fraudulent purpose on the part of both parties. It contemplates the violation of a legal duty to the creditors—that of not misrepresenting in order to make purchases.

When, however, no agreement to keep secret is shown, all that is implied—or the law will assume—is a purpose to remain silent *so long as* this can be done without violating the legal duty to creditors—that is, until questioned by creditors. This is the real basis of the distinction which is found in the mortgage cases (including Sawyer *vs.* Turpin, 91 U. S., 114, and People's Savings Bank *vs.* Bates, 120 U. S., 556), between an agreement to keep secret and an agreement merely not to record.

In this case there is no evidence, nor finding by the masters, of an *agreement* to keep secret. The insistence of counsel to the contrary but emphasizes their appreciation of the importance of the distinction here made. Their whole argument upon secrecy is founded upon the erroneous assumption that there was such an agreement. The only evidence referred to by them to show an agreement for secrecy was that of Charles E. Fargo, who merely said that it was

the purpose to maintain silence respecting the preferential arrangement. Doubtless that was the purpose of Mr. Fargo, as without it his efforts to outlive temporary embarrassment would be rendered nugatory. This is not evidence that there was in January or at any time an agreement for secrecy or that the arrangement contemplated or required that any one would misrepresent to the creditors. The mere fact that a purpose existed to keep silence is not evidence of a purpose to misrepresent when questioned.

The fact that some of the Fargos afterwards made misrepresentations to three of the company's 170 creditors cannot discredit the purpose or affect the rights of the Rubber Companies. They were not in any way connected with these representations, and it cannot be assumed that either they or the Fargos contemplated that such misrepresentations should be made when entering into the arrangement in January. Besides, the cause of action arising to these three creditors by reason of these misrepresentations is not enforceable in this suit, as is shown by the opinion of Mr. Justice Brown. Creditors not misled to their injury cannot make misrepresentations to others the basis of recovery in a class suit like this.

But it is said that the January arrangement should be condemned because thereafter the business was, and was intended to be, continued at the risk of the general creditors. In all business conducted, as most of it now is, largely on credit, the risk of the business is upon the creditors. Where the right to prefer exists, this risk is increased. It then becomes not only a risk that the debtor may not have property enough, but also that he give it all to a favored creditor to the exclusion of all others. This risk involves not only the giving of the preference at the time of the collapse, but that the debtor may previously make a contract to prefer in case of failure. (See cases in the original Brief, pp. 26, 27.) As the law permits an embarrassed debtor to use his right to prefer to aid him in trying to weather the storm, persons

extending credit to him without inquiry always take the risk that he has already exercised his right to prefer in order to obtain money with which to continue the business.

These risks the law imposes on all persons extending credit. They can only be escaped by withholding credit. To say, then, that the January arrangement is to be condemned because thereafter the business was conducted at the risk of the general creditors is in reality to deny the right of the Fargo Company to make a preferential contract in order to secure money with which to weather the storm.

At the outset Respondents' counsel felt it to be necessary, in order to establish fraud, that the parties should, in January, have contemplated subsequent purchases on credit *in order to increase assets* to be seized by the Rubber Companies in satisfaction of their claims. Failing in the proof of this, they now contend that all that is necessary is to show that the parties, in January, contemplated future purchases on credit. This clearly is not sufficient to show actual fraud. Is it enough to make a case of constructive fraud? Certainly not. Substantially all mercantile business is conducted on credit. Whenever an embarrassed debtor engages in an attempt to weather the storm he contemplates future purchases on credit. As the law sanctions this attempt to weather the storm, it necessarily contemplates future purchases on credit in the effort to do so.

Whenever a bank loans a debtor money with which to continue business and takes a judgment note, both parties contemplate a continuance of purchases on credit without giving publicity to the judgment note. When a mortgage given by one in mercantile business is withheld from the record, purchases on credit while it is so withheld are contemplated. To say that the giving of a lien when followed by the purchase on credit is invalid is to resurrect the exploded theory of "secret liens" and "delusive credit" now so distinctly repudiated in Illinois and most of the States.

See Hegeler *vs.* First National Bank, 129 Ill., 157 (cited in the original brief).

It is contended that the January arrangement was equivalent to a recorded chattel mortgage on a stock in trade while the mortgagor remains in possession and sells the property, and is therefore invalid under the decision in *Robinson vs. Elliot*, 22 Wall., 513 (a case afterwards qualified by *Means vs. Dowd*, 128 U. S., 273, and Huntley *vs.* Kingman, 152 U. S., 527). But in Illinois such a mortgage is valid as to all creditors *except such as acquire liens upon the property before the mortgagee takes possession.*

Read *vs.* Wilson, 22 Ill., 377.
Barchard *vs.* Kohn, 157 Ill., 579.
Pinkstaff *vs.* Cochran, 58 Ill. App., 72.

In Illinois also, chattel mortgages withheld from the record are valid, except as to creditors who acquire liens before the mortgagee records it, or takes possession under it.

Frank *vs.* Minor, 50 Ill., 444.
Chipron *vs.* Feikert, 68 Ill., 284.

In the case at bar the petitioners acquired possession under their executions before the liens of the other creditors had attached. Thus, if, despite the manifest difference between them, the January arrangement be treated as like a chattel mortgage, it is not constructively fraudulent.

The foregoing chattel-mortgage cases also show that the secret lien and delusive credit theory is exploded in Illinois.

In Illinois the distinction between actual and constructive fraud is thus stated in *Lawson vs. Funk*, 108 Ill., 502:

"The authorities clearly establish two distinct grounds upon which conveyances and other contracts will be deemed fraudulent as against creditors: First, such as are entered into with a fraudulent intent; and second, *such as from the terms of the agreement or the nature of the transaction itself are deemed so as a mere inference of law*, without regard to the motives or actual intentions of the contracting parties."

To hold this transaction constructively fraudulent, the court must conclusively infer the fraud from its very terms. Those terms must be "plainly inconsistent with an honest purpose" (Huntley *vs.* Kingman, 157 U. S., 527). They must carry on their face inevitable evidence of a fraudulent purpose, and be such that fraud will result as a *necessary consequence* of their performance (Delaney *vs.* Valentine, 49 N. E. Rep. (N. Y.), 65). Tested by these rules, the transaction was not constructively fraudulent, for we have shown that the element of silence or secrecy was entirely consistent with an honest purpose, and it surely cannot be said that there was anything in the other terms of the transaction inconsistent with such a purpose. The fact that no injury resulted to the general creditors is proof conclusive that there was no plain inconsistency with an honest purpose, and that fraud should not be imputed as matter of law.

II.

ACTUAL FRAUD.

There can be no actual fraud here without a *motive or purpose* of the parties to the January arrangement *to injure, or profit at the expense of, the other creditors.* The keystone of this entire arch of fraud so elaborately sought to be erected by counsel is this motive or purpose. Remove it, and the whole falls. But where is such motive? It is not to be found in the desire or purpose of these parties to increase credit assets upon which to levy, for it is now conceded that this was neither intended nor accomplished.

There was no motive to profit at the expense of other creditors; for the Rubber Companies did not so profit by the arrangement. Under it the indebtedness to the general creditors was reduced at least 20 per cent., while that of the Rubber Companies was reduced but 4 per cent.

Nor can there be imputed to the Fargos any motive other than a desire to avoid failure and preserve their business, for they also profited nothing by the January arrangement. It is sought to find an improper motive on their part in the fact that in January they were endorsers on $15,000 of the company's paper, which was subsequently paid. But if this was their motive in January the arrangement then made was not necessary. Under the Illinois law this object could have been attained by a direct preference at that time to the creditors holding these $15,000 of notes. The fact that the Fargos were endorsers did not prevent the Fargo Company from then giving such preference. It was not, as claimed, necessary to prolong the company's existence to get rid of the personal liability of the Fargos on these notes.

But in the case of actual fraud there must not only be a motive, but injury to creditors, and none is here shown. While counsel attempted to show injury to particular creditors, it must be apparent that in considering injury, as well as motive, the creditors must be treated as a whole. When so considered, the continuance of the business for the seven months did not injure the general creditors, nor did it better the situation either for the Fargos or the Rubber Companies. Had they entertained in January an improper motive to sacrifice the general creditors, they could have better accomplished it by rendering the preferences effective at once, when the assets were larger than in August.

After all is said, these Respondents concede the right to give these preferences in January, and are only complaining because they were not consummated until August. But this delay inured to their benefit. *Thus their complaint is in reality but the frequent one against the exercise of the right to prefer, and this, too, when the disadvantages to them from the exercise of this right were mitigated by the seven months' continuance of the business.*

III.

INACCURATE STATEMENTS BY RESPONDENTS' COUNSEL.

We desire to call attention here to some of the inaccurate statements into which the zeal of Respondents' counsel has betrayed them.

It was said that of the $50,000 advanced in January $44,900 went right back to the Candee Company in payment of the antecedent indebtedness to that company, which it was also said was evidenced by past-due notes. This is incorrect. The $44,900 of notes of the Candee Company were given in the previous November and matured at different times between January and May 1, 1896. They were paid on the dates on which they became due, just as obligations of other creditors were paid during the same period. The $50,000 advanced went into the business, and there is nothing to show that a single dollar of it was returned to the Candee Company. All that can be said is that during the seven months of operation after the January arrangement over $300,000 were paid out to creditors, including this indebtedness of $44,900 of the Candee Company.

It was also said that in January the Rubber Companies had at stake consigned goods to the extent of $100,000, which by a course of dealing had become commingled with the goods of the Fargo Company so as to be incapable of recovery in case of failure at that time, and that the January arrangement provided for the separation of these goods. It is true that the Fargo Company then had on hand consigned goods of the Rubber Companies, but it is not true that these goods were considered in making the January arrangement, or that any separation of them was then made. Counsel's contention to the contrary rests upon the testimony of one witness to the effect that the consigned goods were discussed in 1896, though this witness afterwards ad-

mitted in substance that he was mistaken (Rec., 345–348), and four witnesses testified positively to the contrary (Rec., 428, 419–421, 498, 499, 504, 559). The entire business of the United States Rubber Company had always been up to that time conducted under consignment contracts like those made with the Fargo Company in April, 1895–1896, as shown in Record, pages 572–581. This was a method of business pursued with all of its customers.

It is said that the Candee Company was merged in the United States Rubber Company in April, 1895. The proof is that the Candee Company on that date ceased selling to the trade and confined its business thereafter to manufacturing. The present indebtedness to it represents the balance unpaid upon the advance of $50,000 made in January, and this indebtedness is entirely independent of that to the United States Rubber Company.

It was said that during the period of operation between January and August the Fargo Company was constantly staving off its indebtedness to its general creditors, while at the same time it was reducing its indebtedness to the Rubber Companies. There is no evidence in the record that any indebtedness was extended except in the single instance of the American Oak Leather Company.

Counsel undertake to charge the Rubber Companies with knowledge of the insolvency of the Fargo Company in January by showing the discrepancy between the liabilities in August and the amount realized from the assets in liquidation. This is manifestly unfair. All the evidence is, and the master finds, that in January the Rubber Companies believed the Fargo Company to be solvent and capable of being tided over to ultimate success.

It is claimed that the fact that after the January arrangement the Fargo Company continued to use its old letter-heads was evidence of fraud. These letter-heads showed that Frank M. Fargo was vice-president and treasurer,

whereas after January he was vice-president only, and that E. A. Fargo was secretary, whereas he had ceased to be such in January. There is no testimony that any creditor was deceived by these letter-heads and extended credit in reliance upon their statements. The only evidence on the subject of the letter-heads is that of Charles E. Fargo, president, who said that his company used whatever stationery it had on hand as a mere matter of utility and without any intention of deceiving anybody and without thinking one way or the other about it (Rec., 122).

In the brief of the counsel for the American Oak Leather Company there is also a quotation from Mr. Porter's testimony, appearing in three different places, on the pages 60, 69, and 133. This testimony, as quoted, is not in the record. What Mr. Porter actually said appears in Record, pages 446–7.

Question is made as to the correctness of the master's finding with reference to liabilities of the Fargo Company to other than the preferred creditors in August. He reported them as $142,690.95. These figures were taken from the books. There were some claims in August, growing out of advertising contracts, etc., which were not posted upon the books at the time of the failure and which, in the ordinary course of business, would not be posted until the bills were rendered, and this explains the discrepancy between the finding and the decree, which allows claims aggregating about $165,000. The discrepancy is not material, however, because taking the liabilities in August to the general creditors as $165,000, there is still shown a reduction of about $45,000 from the liabilities to the general creditors in January, which admittedly aggregated $210,216.20.

The partial copies of the letters quoted in counsel's briefs convey an erroneous impression. They should be read in their entirety, and, if this is done, they will demonstrate

that the desire and effort of all parties to the January arrangement was to tide over the Fargo Company to ultimate success, and not to commit a fraud upon creditors.

It is claimed that the Rubber Companies improperly participated in some way in the $10,000 transaction in August between the Fargo Company and the Metropolitan Bank. There is no evidence in the record that the Rubber Companies or their attorney had any knowledge at that time of the purpose to use the $10,000 as it was used. On August first Charles E. Fargo told Mr. Sadler, the representative of the Rubber Companies, that the Fargo Company wished to borrow $10,000 more from the bank to be used in continuing its business, and in order to get it wanted to give the bank judgment notes for the bank's entire claim as thus increased. At that time Sadler had no intimation that the company was about to fail (Rec., 535), and he agreed that this might be done. This was a mere partial release on the part of the Rubber Companies of the contract of the Fargo Company not to give judgment notes to others. Afterwards, and before the additional $10,000 was actually obtained from the bank, the Fargo Company had determined to suspend. Mr. Porter, then acting attorney for the Rubber Companies, knew that the money was obtained in contemplation of failure, but there is no evidence that he knew how it was to be used. If any presumption is to be indulged, it is that it was to be used in the discharge of corporate debts, and that Mr. Porter so supposed.

There is nothing in all this that could affect the validity of the preferences of the Rubber Companies, even if the $10,000 transaction should be held to vitiate the preference of the bank.

As to the prorating agreement between the bank and the Rubber Companies, this was made *after* the preference to the bank had been given, and the sole purpose of it, as explained by the testimony of Mr. Porter (Rec., 453), was to situate the

parties precisely, as if one officer had obtained all executions, at the same time, and levied them concurrently. This was necessary because the judgments were to be entered in courts of different jurisdiction.

Respectfully submitted.

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